

IT 98-9

Tax Type: INCOME TAX

**Issue: Unitary - Inclusion of Company(ies) In A Unitary Group
Business/Non-Business (General)
"Throwback" Sales (General)**

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS,
Petitioner**

v.

**XYZ CORPORATION,
Taxpayer**

No. 96-IT-0000

FEIN: 00-0000000

**Linda K. Brongel
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Jeffrey Dorman and Wendy Keith Abbott, of Sonnenschein, Nath & Rosenthal, for taxpayer; Robert Asbille, Special Assistant Attorney General, for the Department of Revenue.

SYNOPSIS:

. This case involves "XYZ" Corporation ("XYZ" or "taxpayer") for the tax years ending December 31, 1990 through December 31, 1992. On February 16, 1996, the Department of Revenue issued a Notice of Deficiency against the taxpayer in the amount of \$1,716,719, including interest and penalties. "XYZ" timely protested this Notice of Deficiency on April 23, 1996.

At issue is whether capital gains received by "XYZ" on the sale of 20% of the stock of one of its subsidiaries, the insurance holding company "Payout" Insurance ("Payout"),

should be included in “XYZ”’s business income under IITA §1501(a)(1).¹

On consideration of these matters, it is recommended that these issues be resolved in favor of the taxpayer.

FINDINGS OF FACT:

1. “XYZ” is a Virginia corporation with its corporate headquarters in “Someplace”, Virginia. (Tr. pp. 86-87) In 1992 “XYZ” filed an Illinois combined income tax return with its unitary subsidiaries which manufacture chemical products consisting of lubricant additives, fuel additives, specialty chemicals, industrial chemicals, pharmaceutical chemicals and electronic materials. (Tr. p. 201)
2. In 1982 “XYZ” Insurance Company (later “Payout” Corporation), a wholly-owned subsidiary of “XYZ”, purchased the stock of “Payout” Life Insurance Company (“Payout” Life) for \$270 million. (Tr. p. 184, Jt. Ex. No. 6) “Payout” was formed for federal tax purposes to acquire and hold the stock in “Payout” Life. (Tr. pp. 185, 228-229)
3. “XYZ” financed the purchase by borrowing \$200 million from a group of banks, raising \$45 million from the issuance of preferred stock and taking \$25 million from its general corporate funds. (Tr. p. 185)
4. “Payout” Life was experiencing rapid growth and needed a cash infusion to maintain the reserves required by insurance regulations. “XYZ” was able to provide the necessary capital. (Tr. pp. 124-126)

¹ Unless otherwise noted, references to sections are to the Illinois Income Tax Act, 35 ILCS 5/101 et seq.

5. “Payout” Life sells life insurance policies and settlement annuities. (Tr. p. 128) “XYZ” was not in the life insurance business or financial products business up until that time. (Tr. p. 101)
6. “Payout” never was licensed to sell insurance, never had any operations and never had any employees. (Tr. p.189)
7. “Payout”’s assets consisted of the stock of “Payout” Life and approximately \$100,000 in bonds. (Tr. p. 187) The value of the stock of “Payout” is due to the value of the operations of “Payout” Life. (Tr. pp. 53-54, 146)
8. The majority of “Payout”’s officers and directors were officers and directors of “XYZ”. “John Doe”, the president of “XYZ”, served as chairman of “Payout”. In 1992 he was replaced by his son, John Doe, Jr. (Jt. Ex. No. 77)
9. In 1992 “XYZ” sold 20 percent of the stock in “Payout” for \$271.6 million which resulted in a capital gain of \$174,469,174. (Jt. Ex. No. 7, Jt. Ex. No. 42, p. 41) “XYZ” reported the gain as non-business income on its Illinois income tax return. (Jt. Ex. No. 6)
10. In 1993 “XYZ” spun off the remaining stock of “Payout” to its shareholders. (Jt. Ex. No. 43, p. 43)
11. Prior to the “Payout” spin-off, in December 1992, “Payout” borrowed \$250 million, and immediately declared and paid a dividend of \$250 million to “XYZ”. (Tr. pp. 210-212) This dividend was used to repay long-term debt of “XYZ”. (Jt. Ex. No. 42, p. 20)
12. “XYZ” transferred \$5-\$10 million per year to “Payout” Life by means of “Payout” during 1982 through 1986 to cover their reserve requirements, for a total of \$42.5 million. “Payout” was merely a conduit for the funds. (Tr. pp. 192-194) After 1986, “Payout” Life was completely self-sufficient from a cashflow standpoint. (Tr. p. 196)

13. "Payout" Life paid a total of \$92 million in dividends for the period 1988 to 1992. (Tr. pp. 196-197)
14. Dividends from "Payout" Life were paid to "Payout" and immediately wire-transferred to "XYZ". (Tr. p. 138) "Payout" Life's management would determine the amount of the dividend. "XYZ" had no role in determining the amount of the dividend. (Tr. pp. 138-139) "Payout" was directed by "XYZ" to approve a dividend payment in the same amount as the dividend it received from "Payout" Life. (Tr. pp. 140-141)
15. "Payout"'s income was derived from the dividends received from "Payout" Life and the \$5,000 or \$6,000 in interest received from the bonds. (Tr. p. 190)
16. Minimal accounting services were provided by "XYZ" to "Payout": two man-days for accounting services and one man-day for taxes per year. (Tr. p. 191)
17. "Payout" never required the legal services of "XYZ". (Tr. p. 191)
18. "Payout"'s headquarters consist of a file cabinet in a secretary's office at "XYZ" headquarters in "Someplace", Virginia. (Tr. p. 186)
19. "Payout" Life's headquarters are in "Elsewhere", Virginia. "Payout" Life and "XYZ" shared no office space or other facilities. (Tr. p. 136)
20. During the 11-year period that "XYZ" owned "Payout" Life, the initial management was not replaced by "XYZ" personnel. (Tr. p. 134)
21. There were no inter-company sales between "XYZ" and "Payout" Life. (Tr. p. 203)
22. "Payout" Life maintained its own legal staff, accounting staff, and managed its own payroll. (Tr. pp. 135-136)
23. "Payout" Life and "XYZ" had separate benefit and pension plans. (Tr. p. 136)

24. "Payout" Life retained its own outside counsel and its own outside auditors. (Tr. pp. 135-136)
25. "Payout" Life prepared its own tax filings. (Tr. p. 147)
26. There was no interchange of personnel between "XYZ" and "Payout" Life. (Tr. p. 135)
27. "XYZ" provided no corporate services for "Payout" Life, nor did "Payout" Life provide services to "XYZ". (Tr. p. 135)
28. "XYZ" maintains a centralized cash management program for its domestic chemical operations. (Tr. p. 192)
29. As of 1992, the year of the sale, of the 89 officers of "Payout" Life, 2 were current or former employees or directors of "XYZ". (Tr. p. 129) The "Payout" Life Board of Directors varied between nine and ten directors. In 1982 "XYZ" placed three of its own directors/officers on "Payout" Life's Board of Directors, "Ron Doe", Jr., "XYZ"'s chairman, "John Doe", "XYZ"'s president and "Ripper Taylor", "XYZ"'s chief financial officer. In 1985 "XYZ" placed four of its directors/officers on "Payout" Life's Board, and in 1989 it placed five. In 1991 "XYZ" restructured "Payout" Life's Board of Directors and placed a majority, five of nine, of the directors. In 1992 six of ten "Payout" Life directors were either officers or directors of "XYZ". (Jt. Ex. 77)
30. "Payout" Life did not report to anyone within "XYZ". Other acquisitions made by "XYZ" typically reported to the vice president in charge of that division. (Tr. pp. 128-129)
31. "Herman Munster" was one of two officers of "XYZ" that were also officers of "Payout" Life. His function was primarily ministerial. Since "Payout" Life was based in "Elsewhere" and the state commission that regulates insurance companies is located in "Someplace", it was more convenient to have an officer of "Payout" Life available in "Someplace" to execute documents

rather than to go back and forth to “Elsewhere”. No employee of “XYZ” ever served as president, executive vice president, treasurer, controller or chief operating officer of “Payout” Life. (Tr. pp. 131-132)

32. “XYZ” and its Subsidiaries (non-insurance) and “Payout” Life and its Subsidiaries used separate financial statements to report their results to the Securities and Exchange Commission in the Form 10-K for the years 1982 through 1992. (Jt. Ex. Nos. 62-72)

33. During the period 1963-1996 “XYZ” acquired 12 corporations or product lines that were eventually spun off. The average length of time they were operated by “XYZ” is 12 ½ years. (Tr. p. 224, Taxpayer Ex. No. 2)

34. During the period 1963 to 1996 “XYZ” acquired 16 companies that were eventually sold. The average length of time they were operated by “XYZ” is 8.6 years. (Tr. p. 225, Taxpayer Ex. No. 3)

35. “Flimsy” Paper Co. (“Flimsy”) was the predecessor corporation to the current “XYZ” Corporation. In 1962 “Flimsy” purchased the stock of “XYZ” Corporation which was owned 50 percent by “One Big Corporation and 50 percent by “Another Big Corporation”. “XYZ” was merged into “Flimsy”, and the name of the surviving corporation was changed to “XYZ” Corporation. (Tr. p. 86, Jt. Ex. No. 6) At the time of the acquisition of “XYZ”, the chairman of “Flimsy” was “Ron Doe”, who became the chairman of “XYZ”.

36. In 1962 “XYZ”’s primary business was petroleum additives. Other divisions of the company were specialty chemicals, vinyl monomer plastics and paper. (Tr. p. 87)

37. After 1962 “XYZ” diversified into additional product lines. Approximately one-half of the new product lines were developed internally, and one-half were acquired from other companies. (Tr. pp. 87-88)

38. Between 1962 and 1992 “XYZ” acquired approximately 30 businesses and product lines. (Tr. p. 89)

39. In 1963 “XYZ” acquired “Upchuck” polyethylene film operations from “Big Name Corporation”, and became a division of “XYZ”. The acquisition fit into “XYZ”’s operations since “XYZ” was already supplying vinyl chloride monomer. In 1989 the business was contributed to a wholly-owned subsidiary of “XYZ”, “Headgear” Industries, Inc., whose stock was spun off to “XYZ”’s shareholders in the same year. (Tr. p. 92, Jt. Ex. No. 6)

40. In 1964 “XYZ” acquired a 50 percent interest in “Whirlybird” Corp. “Whirlybird” made polyvinyl chloride bottles and containers. Since “XYZ” was already in the monomer business, and it sought to enter the polymer business, it needed to acquire a manufacturing operation. (Tr. pp. 92-93) The remaining 50 percent was acquired in 1967. The company was merged into “XYZ” in 1969, and the manufacturing assets were contributed to “XYZ”’s wholly-owned subsidiary, “Holds-a-Lot” Container Company in the same year. (Jt. Ex. No. 6)

41. In 1965 “XYZ” acquired the stock of “Billy The Kid” Company. “Bill The Kid” produced aluminum extrusions and fabricated aluminum parts, products, doors and windows. “XYZ” had been developing a process to extract aluminum from kyanite ore and had bought property in Tennessee that was rich in kyanite. “XYZ” acquired “Billy The Kid” in order to have an outlet for the aluminum metal once the process was commercialized. (Tr. p. 93) In 1989 the stock of “Billy The Kid” was contributed to “Headgear” and the stock of “Headgear” was spun off in the same year. (Jt. Ex. No. 6)

42. In 1966 “XYZ” acquired “Leaks-Right-Thru” Paper. “XYZ” was currently in the kraft paper business and wanted to compete in the overall paper products business so it purchased

“Leaks-Right-Thru” to acquire a bleached paper product operation. (Tr. p. 94) “Leaks” was merged into “XYZ”. (Jt. Ex. No. 6)

43. In 1968 “XYZ” acquired the stock of “Holds-a-Lot” Container Co. “Holds-a-Lot” was a supplier of plastic bottles and containers to the cosmetics industry and it fit into “XYZ”’s current plastics operations. (Tr. p. 94)

44. In 1968 “XYZ” sold the manufacturing assets of “Flimsy” Paper since it was no longer competitive. (Tr. pp. 94-95)

45. In 1969 “XYZ” purchased “123” Products Corp. “123” Products manufactured aluminum doors and windows, and its acquisition was complementary to the acquisition of “Billy The Kid” Company. The stock of this company was contributed to “Headgear” in 1989, which was spun off in the same year. (Tr. p. 95, Jt. Ex. No. 6)

46. In 1970 “XYZ” purchased “Ah-chew” Inc. “Ah-chew” measured lead and manganese in the air and was added to “XYZ”’s refinery systems group. (Tr. p. 95)

47. In 1972 “XYZ” acquired the stock of “Mixed-Up” Corp. “Mixed-Up” had equipment to measure lead and manganese in gasoline. “Mixed-Up” was added to the refinery systems group. (Tr. p. 96) “Mixed-Up” was merged into “XYZ” in 1976. (Jt. Ex. No. 6)

48. In 1974 “XYZ” acquired the stock of “Big Sheep” Corp. “XYZ” acquired “Big Sheep” because it was a coal producer, and following the energy crisis “XYZ” wanted to expand into alternative sources of energy, and also, “XYZ” was developing chemicals from coal and needed a source. (Tr. p. 96) The stock of this company was contributed to “Headgear” in 1989 and “Headgear” was spun off in the same year. (Jt. Ex. No. 6)

49. In 1974 “XYZ” acquired the stock of “Cheeso” Corp (name was subsequently changed to “XYZ” Products Company). “Cheeso” made plastic parts: spray can valves, plastic containers,

and caps closures. “Cheeso” fit in directly with “XYZ”’s marketing since “XYZ” was currently selling them plastic bottles manufactured by “Holds-a-Lot”, and “Cheeso” had the cap. In 1983 a portion of the business was contributed to a wholly-owned subsidiary of “XYZ”, “XYZ Bottled” Products Corporation. In 1989 the stock of “XYZ Bottled” Products was contributed to “Headgear” and “Headgear” was spun off in the same year. (Tr. p. 97, Jt. Ex. No. 6)

50. In 1975 “XYZ” acquired “Fenimore”, Inc. “Fenimore” manufactured lubricant additives for motor oil. “XYZ” had been conducting research in the area for years without success, and the acquisition of “Fenimore” would give them access to the field. (Tr. p. 98) “Fenimore” remains as part of “XYZ”’s core business. (Jt. Ex. No. 6)

51. In 1976 “XYZ” sold “Ah-chew” Inc. Pressure was being put on the refineries to eliminate lead from gasoline, so there was no longer a market for equipment to measure the lead in the air. The company was no longer making money so it was sold. (Tr. p. 98)

52. In 1976 “XYZ” sold “Leaks-Right-Thru”. “Leaks” had big pollution problems in its plant in “Big State”. Since the cost to correct the problem was not justified, it was sold. (Tr. pp. 98-99)

53. In 1977 “XYZ” bought “Soapsuds” Systems. “Soapsuds” Systems was a plastic spray pump manufacturer. It had the same product line and customers as “Cheeso”. (Tr. p. 99)

54. In 1977 “XYZ” sold its interest in “Chingachgook” Labs. “XYZ” held 12 percent of the stock of “Chingachgook” Labs. “XYZ” wanted to be in the drug business from a manufacturing and technology standpoint but disposed of its interest in “Chingachgook” when it became too expensive. (Tr. pp. 99-100)

55. In 1977 “Big Sheep” Coal sold its investment in “Daniel Boone” Coal Company. (Jt. Ex. No. 6)

56. In 1978 “XYZ” purchased stock of “Cedrick” Chemical Co. “Cedrick” manufactured various specialty chemicals and was a customer of “XYZ”’s bromine product. (Tr. p. 100, Jt. Ex. No. 6)

57. In 1980 “XYZ” purchased stock of “Say-so” Inc. “Say-so” manufactured flame retardants, most of which contain bromine. “Say-so” had been a customer of “XYZ”’s. (Tr. p. 100) “Say-so” was merged into “XYZ” in 1984 as part of “XYZ”’s bromine products division. The assets of this division were contributed to “Flimsy” Corporation in 1994 and the stock of that company was spun off to “XYZ”’s shareholders that year. (Jt. Ex. No. 6)

58. In 1983 “XYZ” sold its polyvinyl chloride resin and compounds division. “XYZ” disposed of it because it was no longer cost efficient. (Tr. p. 102)

59. In 1983 “Big Sheep” Coal Corporation, a wholly-owned subsidiary of “XYZ”, acquired “Chew-chew” Coal Processing. “Chew-chew” Coal mined and processed raw coal by washing it to remove mud and rocks. “XYZ” believed it would be able to sell more coal and get a better price in the washed state than as raw mined coal. (Tr. p. 103, Jt. Ex. No. 6)

60. In 1983 “XYZ” Products Company, a wholly-owned subsidiary of “XYZ”, acquired “Raymond” Tool and Mold Co. “Raymond” made molds used by “Holds-a-Lot” and “Cheeso” for injected molding of plastics. (Tr. p. 103, Jt. Ex. No. 6)

61. In 1984 “XYZ” sold “XYZ” Products. “XYZ” Products was part of the “Cheeso” acquisition. It was sold because profitability was down and there were problems with management. (Tr. pp. 103-104)

62. In 1984 “XYZ” sold “XYZ” Development Co. which was formerly “Holds-a-Lot” Container Co. It was sold because profitability was down and there were problems with management. (Tr. p. 104)

63. In 1984 “XYZ” acquired a 50 percent interest in “Oompah”. “Oompah” managed benefits with software. It was acquired as a tool to sell “Payout” Life products. “Oompah” reported directly to the CFO of “Payout” Life, “Georgio Buffoni”. (Tr. p. 105)
64. In 1984 “XYZ” purchased “Lancelot”. “Lancelot” manufactured vinyl doors and windows. In 1989 the stock of this corporation was contributed to “Headgear” which was spun off in the same year. (Jt. Ex. No. 6)
65. In 1985 “XYZ” acquired “Fizzler” Semiconductor. “XYZ” was in the polysilicon business, and polysilicon pellets are used to make computer chips. “Fizzler” made gallium arsenide wafers and since it appeared that gallium arsenide had the ability to put many more circuits on a smaller chip than polysilicon, “XYZ” wanted to acquire the new technology. (Tr. pp. 105-106)
66. In 1985 the assets of the refinery systems division were disposed of. (Jt. Ex. No. 6)
67. In 1986 “XYZ” acquired “Farquar”. “Farquar” made flame retardant foam which fit in with the product line of “Say-so”. (Tr. p. 106)
68. In 1986 “XYZ” purchased the remaining 50 percent of the “Oompah” Group. (Jt. Ex. No. 6)
69. In 1987 “XYZ” acquired “Very Big” Chemical’s bromine business. “Very Big” had a plant and brine reservoir in “State” next to the ones “XYZ” had. “XYZ” acquired the company in order to get long-term supply contracts of brominated products, a good supply and technological position along with a manufacturing plant. (Tr. pp. 106-107) This business was integrated into the bromine division of “XYZ”. In 1994 the assets of this business were contributed to “Flimsy”, which was spun off in the same year. (Jt. Ex. No. 6)
70. In 1987 “XYZ” Acquisitions Corporation, a wholly-owned subsidiary of “XYZ”, acquired the stock of “Upsilon” Research and Development. “Upsilon” Research was in the business of

developing drugs. The name of the parent corporation was changed to “Batboy” Inc. and the name of “Upsilon” Research was changed to “Batboy” Research Inc. (Tr. p. 107, Jt. Ex. No. 6)

71. In 1988 “XYZ” sold its interest in “Whiskers” Corp. “Whiskers” was in the business of manufacturing chemicals, plastics and drugs. “XYZ” attempted to acquire them, but “Whiskers” management was not receptive to the acquisition and ultimately a “foreign” company purchased “Whiskers”. “XYZ” then sold its holdings. (Tr. p. 107)

72. In 1988 “Big Sheep” Coal sold “Chew-chew” Coal Processing. Coal processing was not successful as a marketing tool, so “Chew-chew” was disposed of. (Tr. p. 108)

73. In 1989 “Batboy”, which was responsible for “XYZ”’s drug operations, acquired “Busybody” Pharmaceuticals. “Busybody” was a packager and distributor of drug products. (Tr. p. 109) These product lines were sold with “Batboy” in 1994. (Jt. Ex. No. 6)

74. In 1989 “Headgear” Industries was spun off to “XYZ”’s shareholders. “Headgear” took the aluminum, plastics, oil and gas, and coal operations of “XYZ”. (Tr. pp. 109-110) After the spin-off, “John Doe” became the chairman of “Headgear”. (Tr. pp. 159-160)

75. In 1990 “Batboy” acquired various pharmaceutical product lines from “Aardvaark” Holdings. (Tr. p. 110) These product lines were sold with “Batboy” in 1994. (Jt. Ex. No. 6)

76. In 1990 “XYZ” sold “Cedrick” Chemical. “Cedrick” had experienced a turnover in management and their primary customer was losing business to other chemicals. “XYZ” decided that growth prospects were not there so it was disposed of. (Tr. p. 111)

77. In 1990 “XYZ” acquired the polyalpha olefins manufacturing assets of “Beefeater” Chemical. “XYZ” was already in the business of producing olefins. (Tr. p. 111) These assets were contributed to “Flimsy” in 1989, with “Flimsy” being spun off in the same year. (Jt. Ex. No. 6)

78. In 1991 “Batboy” acquired various pharmaceutical product lines from “Another Big Company”. (Tr. p 112) These product lines were sold with “Batboy” in 1994. (Jt. Ex. No. 6)

79. In 1992 “XYZ” Petroleum Additives, Inc. (formerly “Fenimore”, Inc.) purchased the petroleum additives business of “Still Another Big Company”. (Tr. p. 113, Jt. Ex. No. 6)

80. In 1993 “XYZ” purchased the stock of “Vous le Vous”, a “foreign” corporation that was in the business of manufacturing bromine products and bromine derivatives. (Tr. p. 113) In 1994 the stock of this company was contributed to “Flimsy” which was spun off in the same year. (Jt. Ex. No. 6)

81. In 1993 “XYZ” sold the stock of the “Oompah” Group. (Jt. Ex. No. 6)

82. In 1994 “XYZ” spun off “Flimsy” to the shareholders. “Flimsy” took the specialty chemicals division and set up as a separate company. (Tr. p. 112, Jt. Ex. No. 6) After the spin-off, “Ron Doe”, Jr. became chairman of “Flimsy”. (Tr. p. 161)

83. In 1994 “XYZ” sold “Batboy” and “Batboy” Research. The cost of the research program had become too great. “XYZ” decided to restrict itself to the manufacture of bulk chemicals. (Tr. pp. 114-115)

84. In 1996 “XYZ” Petroleum Additives purchased the petroleum additives business of “Bumper” Additives Corporation. (Jt. Ex. No. 6)

85. The following businesses or product lines were disposed of by “XYZ”:

	<u>Year Acquired</u>	<u>Year Disposed of</u>	<u>Method</u>
“Upchuck”	1963	1989	Spin-off
“Whirlybird”	1964	1984	Sale
“Billy The Kid” Co.	1965	1989	Spin-off
“Leaks-Right-Thru” Paper Co.	1967	1976	Sale
“Holds-a-Lot” Container Co.	1968	1984	Sale
“123” Products Corp.	1969	1989	Spin-off

"Ah-chew", Inc.	1970	1976	Sale
"Mixed-Up" Corporation	1972	1985	Sale
"Cheeso" Corporation ²	1974	1984/1989	Sale/Spin-off
"Big Sheep" Coal Co.	1974	1989	Spin-off
"Soapsuds" Dispensing Systems	1977	1984	Sale
"Cedrick" Chemical Co.	1978	1989	Sale
"Say-so", Inc.	1980	1994	Spin-off
"Payout" Life Ins. Co. ³	1982	1992/1993	Sale/Spin-off
"Chew-chew" Coal Processing	1983	1988	Sale
"Lancelot"	1984	1989	Spin-off
"Fizzle" Semiconductor Co.	1985	1989	Sale
"Oompah" Group Inc.	1985	1993	Sale
"Very Big" bromine business	1985	1994	Spin-off
"Farquar" Corporation	1986	1994	Spin-off
"Upsilon" Research & Dev. Corp.	1987	1994	Sale
"Busybody" Pharmaceuticals, Inc.	1989	1994	Sale
"Aardvaark" product lines	1990	1994	Sale
"Beefeater" PAO business	1990	1994	Spin-off
"Another Big Corp." product lines	1991	1994	Sale
"Vous le Vous"	1993	1994	Spin-off

Joint Ex. No. 2,3

86. The following businesses were acquired by "XYZ" and continue to be operated by "XYZ":

	Year <u>Purchased</u>
"Fenimore" Corp.	1975
"Still Another Big Corp." PA	1992
"Yet Still Another Big Corp" PA	1996

Joint Ex. No. 4

87. "XYZ"'s Manager of Tax Compliance made the determination to report the gain on the sale of First "Payout" stock as non-business income on "XYZ"'s Illinois income tax return. He based his decision on his analysis that "XYZ" and "Payout" Life were in different lines of business and there was no integration between the companies, so that they were not unitary. In addition, he

² The Specialty Packaging portion of the business was sold in 1984. The "Bottled" Products portion was spun-off in 1989.

sought the advice of Coopers & Lybrand, “XYZ”’s outside auditors, who advised that based upon decisions of the Supreme Court (Allied Signal, F.W. Woolworth and ASARCO, cited below), “XYZ” should treat the gain as nonbusiness income in Illinois. (Tr. pp. 214-219, Jt. Ex. No. 11)

CONCLUSIONS OF LAW:

The issue in this case is whether “XYZ” Corporation is subject to tax by the State of Illinois on the gain on the sale of the stock of First “Payout” Corp. (“Payout”). “Payout” is a wholly-owned subsidiary of “XYZ” which acts as the holding company for the life insurance subsidiary of “XYZ”, “Payout” Life Insurance Co. (“Payout” Life).

In 1962, “Flimsy” Paper Co. (“Flimsy”) acquired “XYZ” Corporation. “XYZ” was in the business of making petroleum additives, its major product being an anti-knock compound. After completion of the merger, “Flimsy” changed its name to “XYZ”.

At the time of the merger, “XYZ” had three divisions in addition to the manufacture of petroleum additives: specialty chemicals, vinyl monomer plastics and paper. After 1962, “XYZ” began a program of diversification into other product lines. Approximately one-half of the new product lines were developed internally and the other one-half were acquired from other companies. Typically the new product lines were acquired because they fit into “XYZ”’s current operations.

For example, “XYZ” acquired a polymer plastics operation to expand on its monomer plastics business. Then “XYZ” acquired a manufacturer of plastic containers which would utilize the plastics which “XYZ” made. Following the acquisition of the plastic bottle

³ 20% of the company was sold in 1992. The remaining 80% was spun-off in 1993.

manufacturer, a plastic cap manufacturer was acquired which would utilize the same marketing resources.

As another example, “XYZ” had internally developed a process to extract aluminum from kyanite ore and had acquired property in Tennessee which was rich in kyanite ore. “XYZ” then acquired an aluminum parts manufacturer which would utilize the aluminum which was produced.

Likewise, “XYZ” chose to expand its current paper business which involved the manufacture of kraft paper by acquiring a bleached paper operation. Other companies and product lines were acquired which fit into “XYZ”’s overall strategic plan for growth and diversification during the period 1962 through 1996. Companies which no longer met their objectives were disposed of.

The acquisition of “Payout” Life was unlike the other acquisitions. Insurance did not fit into “XYZ”’s current product lines. “XYZ” had no insurance or financial products prior to the acquisition of “Payout” Life. “Payout” Life needed an infusion of capital in order to meet its reserve requirements to sustain continued growth, and “XYZ” had excess cash.

The Department argues that the gain on the sale of “Payout” stock is business income pursuant to the decisions in National Realty and Investment Co. v. Department of Revenue, 144 Ill. App. 3d 541 (2nd Dist. 1986); Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995); Kroger Co. v. Department of Revenue, 284 Ill. App. 3d 473 (1st Dist. 1996); and Texaco Cities Service Pipeline Co. v. McGaw, 286 Ill. App. 3d 529 (1st Dist. 1997), *aff’d* 1998 Ill. LEXIS 366 (1998). These decisions interpreted the language of §1501(a)(1) as establishing two tests for business income: the transactional test and the functional test, and if either test is met the income is business income. The Department’s reliance on these cases is

misplaced. These cases deal with the treatment of a corporation's own earnings, as opposed to the intangible income received from a subsidiary corporation in the form of dividends or capital gains on the sale of its stock.

The threshold issue here is whether Illinois has the power to tax "XYZ", a non-domiciliary corporation, on the capital gain derived from the sale of the stock of "Payout", a wholly-owned subsidiary. In order for Illinois to have the power to tax the capital gains, there must be a minimal connection between the interstate activities and the taxing State. Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980); Allied-Signal, Inc. v. Director, 504 U.S. 768 (1992). One means of meeting the constitutional requirement of minimal connection is by showing a unitary relationship between the parent and subsidiary whose intangible income is sought to be taxed. Allied Signal at 787.

The auditor attempted to make this connection by focusing on whether "Payout" is unitary with "XYZ". The auditor determined that "Payout" and "XYZ" are unitary because there are common officers and members of the board of directors who determine the amount of dividends paid to "XYZ", they share the same corporate headquarters and "XYZ" provides certain corporate services for "Payout". As a result, he included "Payout" in "XYZ"'s combined group, and found that the capital gains received by "XYZ" from the sale of 20% of "Payout"'s stock is business income.

"Payout", however, was formed by "XYZ" for the sole purpose of acquiring and holding the stock of "Payout" Life and has no operations of its own. "Payout" acts merely as a conduit for the dividends declared by "Payout" Life. Although "XYZ"'s officers direct that the dividend received from "Payout" Life be dividended immediately to "XYZ" upon its receipt by "Payout", it is "Payout" Life that determines the amount of the dividend and this amount is always the

dividend that is wire-transferred to “XYZ”. “Payout”’s “corporate headquarters” consists of nothing more than a file cabinet at “XYZ”’s headquarters. The extent of the corporate services provided by “XYZ” to “Payout” likewise is minimal, consisting of three man-days of accounting services. “Payout” has no operational connection with “XYZ”, it is merely a holding company for the stock of “Payout” Life.

As the holding company for “Payout” Life, “Payout” could properly be included with the unitary business group of “Payout” Life. Section 1501(a)(27) recognizes the relationship between holding companies and their single-factor subsidiaries, and includes them within the definition of a unitary group even though the holding company would not otherwise be includable with a single-factor company.

As the Department concedes at hearing, the value of “Payout”’s stock derives wholly from the value of the stock of “Payout” Life. (Tr. pp. 53-54) Since “Payout” is just a holding company, the proper inquiry here, then, is not whether “Payout” has a unitary relationship with “XYZ”, but whether “Payout” Life is unitary with “XYZ”. By merely interposing a holding company, with no independent operations, between it and “Payout” Life, “XYZ” cannot have changed the character of the income it receives from “Payout” Life. If the same income would have been non-business income had it been received directly by “XYZ” from “Payout” Life, the fact that it passed through “Payout” on its way to the ultimate parent cannot transform it into business income. Therefore, the treatment of the capital gains received by “XYZ” from the sale of the stock of “Payout” should be the same as if the stock of “Payout” Life had been sold. The asset which has value to “XYZ” is the stock of “Payout” Life, not the stock of “Payout”. Accordingly, it is necessary to examine the relationship between “XYZ” and “Payout” Life to

determine if there is sufficient connection between them to subject the capital gains received on the sale of stock to taxation by the State of Illinois.

By statute “Payout” Life cannot be combined with “XYZ”. Section 1501(a)(27) of the IITA states: “In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304.” “XYZ” is required to use a three-factor formula pursuant to §304(a) and “Payout” Life, as an insurance company, uses a single-factor formula based on direct premiums written pursuant to §304(b).

While “Payout” Life cannot be unitary with “XYZ” for purposes of filing a combined return in Illinois, the question is rather, from a constitutional standpoint, whether the business operations of “Payout” Life and “XYZ” are so interrelated that the income received from the disposition of the stock of a subsidiary of “XYZ”’s may be taxed by the State of Illinois. Allied Signal at 787. While there is no question that “XYZ” and “Payout” Life are not unitary under §1501(a)(27), I believe an inquiry as to whether their operations are “unitary” is necessary in order to meet the constitutional guidelines which have been set out in a long line of Supreme Court cases. *See Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982), F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico, 458 U.S. 354 (1982), Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980), Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980). The Supreme Court has held that the same constitutional standards apply to the apportionment of capital gains as to dividends, (ASARCO, 458 U.S. at 330) (“One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability”), so that these cases apply with equal force to the facts here.

At the outset, I do not believe Allied Signal requires that the taxpayer be unitary with the corporation that is the source of the intangible income, be it from dividends or the capital gains on the sale of stock. However, whether or not the corporations are unitary is certainly the first inquiry, since a unitary relationship will establish the minimal connection for constitutional purposes. Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980). The Supreme Court stated in Allied Signal:

We agree that the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. Container Corp. says as much. What is required instead is that the capital transaction serve an operational rather than an investment function. 504 U.S. 768, 787.

The constitutional criteria to determine whether a unitary relationship exists are set forth in Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178 (1983), *see also* F.W. Woolworth Co. v. Taxation and Revenue Department, 458 U.S. 354, 364 (1982); Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 438 (1980); Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 782 (1992). The factors the Court looked to in Container were functional integration, centralization of management and economies of scale. The record here shows little functional integration between “XYZ” and “Payout” Life. “Payout” Life was responsible for its day-to-day operations. Because “XYZ” and “Payout” Life are not in the same line of business there can be no centralized purchasing, manufacturing or warehousing of material. There were no inter-company sales between “XYZ” and “Payout” Life. “Payout” Life and “XYZ” shared no office space or other facilities. “Payout” Life maintained its own legal staff, accounting staff, and managed its own payroll. “Payout” Life and “XYZ” had separate benefit and pension plans. “Payout” Life retained its own outside counsel and its own outside auditors. “Payout” Life prepared its own tax filings. There was no interchange of personnel between “XYZ” and

“Payout” Life. “XYZ” provided no corporate services for “Payout” Life, nor did “Payout” Life provide services to “XYZ”. Furthermore, there is no vertical integration between “XYZ” and its other subsidiaries and “Payout” Life. “Payout” Life neither utilizes any of the products produced by “XYZ” or its other subsidiaries, nor does it provide life insurance to “XYZ”. Vertical integration is easily seen in the other product groups of “XYZ”, for example, where “XYZ” extracts the kyanite ore, processes aluminum from the ore and then uses the aluminum for manufactured parts. The same is not true for “Payout” Life.

The flow of funds is one indication of a unitary business relationship. “XYZ” transferred \$5-\$10 million per year to “Payout” Life by means of “Payout” during 1982 through 1986 to cover their reserve requirements, for a total of \$42.5 million. After 1986, “Payout” Life was completely self-sufficient from a cashflow standpoint. For the period 1988 to 1992, “Payout” Life paid a total of \$92 million in dividends to “Payout” which “Payout” immediately transferred to “XYZ”. The amounts of all dividends were determined by the management of “Payout” Life without direction from “XYZ”.

“XYZ” infused needed capital into “Payout” Life during the first four years of its ownership, but for the last six years “XYZ” owned “Payout” Life, no further infusions were necessary. “Payout” Life maintained its own bank accounts and was not included in “XYZ”’s cash management system.

There is also no indication of strong centralized management of “XYZ” over “Payout” Life. Management of “Payout” Life has remained virtually intact since “XYZ” acquired the company. Of 89 officers, only 2 are also officers of “XYZ”. These common officers provided a purely ministerial function. “Payout” Life did not report to anyone within “XYZ”. Other acquisitions made by “XYZ” typically reported to the vice president in charge of that division.

“XYZ” did place a number of its own officers or directors on “Payout” Life’s Board of Directors. In 1982, “XYZ” placed “Ron Doe”, Jr., its chairman, “John Doe”, its president, and “Ripper Taylor”, its chief financial officer on “Payout” Life’s Board. In 1985, “XYZ” placed four of its directors/officers on “Payout” Life’s Board, and in 1989, it placed five. In 1991, “XYZ” restructured “Payout” Life’s Board of Directors and placed a majority, five of nine, of the directors. In 1992, six of ten “Payout” Life directors were either officers or directors of “XYZ”. While “XYZ” has placed directors on “Payout” Life’s Board, several being members of the “Doe” family, the mere potential to exercise control is not sufficient to show the existence of a unitary relationship. In F.W. Woolworth the Supreme Court stated:

[T]he potential to operate a company as part of a unitary business is not dispositive when, looking at “the ‘underlying economic realities of a unitary business,’” the dividend income from the subsidiaries in fact is “derive[d] from ‘unrelated business activity’ which constitutes a ‘discrete business enterprise.’” 458 U.S. at 362 quoting Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. at 224 quoting Mobil Oil, 445 U.S. at 441, 442, 439.

In fact, Woolworth owned 100 percent of the stock of three of the four subsidiaries at issue, and elected all of their directors. “Woolworth maintained one or several common directors with some of the subsidiaries,” yet all four subsidiaries were found to be non-unitary with Woolworth. The facts in the case at bar are akin to those in Woolworth. “Payout” Life has a high degree of autonomy in its operations. Its operations are not functionally integrated with “XYZ”. “XYZ” has no department or vice president with oversight over “Payout” Life’s operations. The fact that “XYZ” has placed directors on “Payout” Life’s Board of Directors and has invested money in “Payout” Life does not counteract that “Payout” Life is a discrete business enterprise from “XYZ”. The fact that some of these common directors are also members of the same family does not change the result.

The facts before me are virtually the same as the facts in Allied Signal , Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992), *rev'g* Bendix Corp. v. Director, Division of Taxation, 592 A.2d 536, 543 (N.J. 1991). Bendix Corporation (which was later acquired by Allied Signal) sold its 20.6% stock interest in ASARCO Inc. recognizing capital gain of \$211,500,000. Bendix intended to use the proceeds from the sale to purchase Martin Marietta, which presumably would have been operated as part of Bendix's unitary business. The New Jersey Division of Taxation included the capital gain in the apportionable tax base. The Supreme Court of New Jersey ruled in favor the Division of Taxation finding that

Bendix had an ingrained acquisition-divestiture policy designed to expand and enhance its existing operations as well as move it into other fields of business. The long-term planning strategy encompassed a process focused on acquisitions, disposition of unwanted affiliates or divisions, and development of sources of capital for new acquisitions. The divestitures served at times as the capital sources for acquisitions. The strategy went well beyond the passive investments in business enterprises referenced in Container that are distinct from the corporation's main line of business and that have the sole primary function of diversifying the corporate portfolio and reducing risks inherent in being tied to one industry's business cycle...Bendix, during the period under review, essentially had a business function of corporate acquisitions and divestitures that was an integral operational activity....

Bendix Corp. v. Director, Division of Taxation, 592 A.2d 536, 543 (N.J. 1991)

The United States Supreme Court overruled the New Jersey Supreme Court holding:

[C]ontrary to the view expressed below by the New Jersey Supreme Court, ... the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one.

Allied Signal, 504 U.S. 768, 788.

The Department of Revenue here is seeking to resurrect the same argument that New Jersey unsuccessfully made to the Supreme Court: A pattern of acquisitions and divestitures converts an otherwise passive investment into a component of the unitary business. In light of Allied Signal, I must reject the Department's argument.

Further, in ASARCO, the Supreme Court refuted Idaho's argument that intangible income could be treated as earned in the ordinary course of a unitary business if the intangible property which produced that income is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business," and stated:

This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the [corporation's] business." When pressed to its logical limit, this conception of the "unitary business" limitation becomes no limitation at all. 458 U.S. 307, 326.

The Court in Allied Signal did suggest, however, that it was not necessary to make a finding that the businesses are unitary in order to find a sufficient connection with instate activities to subject the income from intangibles to tax. What is required instead is that the capital transaction serve an operational rather than an investment function. Allied Signal, 504 U.S. at 787.

An operational function could be found in a Corn Products-type situation where the stock of a company is acquired to assure a supply of raw materials for a manufacturing concern, or as a hedge against price inflation. *See Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955) (futures transactions found to be an integral part of taxpayer's business where they were designed to protect its manufacturing operations against a price increase in its principal raw material and assure a ready supply) The Court, in Allied Signal, also referred to short-term deposits in a bank located in another state where the deposits form part of the corporation's working capital as an example of an operational function which would subject the interest on the deposits to taxation by the state in which the corporation was located. "XYZ"'s investment in "Payout" Life, however, was not made to provide "XYZ" with a supply of raw materials, and

was clearly more than an interim use of idle funds, so that it does not come within either of these examples of an operational function.

Finally, the Department argues in its brief that “The value of the stock directly related to the operations of “Payout” Life, part of which were conducted in Illinois.” (Dept. Brief p. 28) On page 29, the Department states, “The gain on the sale of the First “Payout” stock directly related to its business operations conducted in Illinois.” The record is devoid of any facts which would substantiate the Department’s assertion that “Payout” Life does business in Illinois. The only statement in the record comes from the auditor’s comments where he writes, “In turn, “Payout” Life Insurance Company filed a unitary return with it’s [sic] subsidiaries that were involved in the insurance business.” (Jt. Ex. No. 6, p. 5) Even if I were to accord this statement any weight, this statement does not reveal the extent, if any, of “Payout” Life’s activities in Illinois. We cannot determine if “Payout” Life had any employees or property in Illinois, or if the unitary return was filed to show no activity. Even if “Payout” Life did have business activities in Illinois, however, it would not seem to change the outcome of the case. In Allied Signal, ASARCO was a New Jersey corporation, yet the Supreme Court did not find that there was sufficient connection with the taxing state to subject Bendix to tax on the capital gain recognized from the sale of ASARCO stock. The Court was not concerned with ASARCO’s level of activity in New Jersey, but rather whether a unitary relationship existed between Bendix and ASARCO. Allied Signal, 504 U.S. at 774. As the Court stated in ASARCO, “We cannot accept, consistently with recognized due process standards, a definition of ‘unitary business’ that would permit nondomiciliary States to apportion and tax dividends ‘[w]here the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State...’” (citing Mobil, 445 U.S. at 442) 458 U.S. at 327. Falling short of a unitary

relationship, Bendix could not constitutionally be subject to tax by New Jersey on the sale of the ASARCO stock.

I find that taxpayer has shown by a preponderance of the evidence that “Payout” Life is a discrete business enterprise, and that the acquisition and disposition of the stock in “Payout” did not serve an operational function. Accordingly, taxpayer has rebutted the Department’s *prima facie* case.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be cancelled in its entirety.

Date:

Linda K. Brongel
Administrative Law Judge